

ORIGINAL

# OPEN MEETING



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## MEMORANDUM

Arizona Corporation Commission

DOCKETED

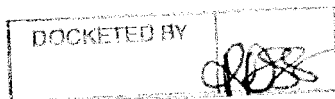
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2011 APR 14 A 10:23

TO: THE COMMISSION

APR 14 2011

FROM: Utilities Division



ARIZONA CORPORATION COMMISSION  
DOCKET CONTROL

DATE: April 14, 2011

RE: IN THE MATTER OF THE APPLICATION OF JOHNSON UTILITIES, L.L.C.,  
FOR AN INCREASE IN ITS WATER AND WASTEWATER RATES FOR  
CUSTOMERS WITHIN PINAL COUNTY, ARIZONA (DOCKET NO. WS-02987A-  
08-0180)

### I. Introduction and Background

In Decision No. 71854, dated August 24, 2011, the Arizona Corporation Commission ("Commission") ordered Johnson Utilities, LLC ("Johnson" or the "Company") to submit an action plan regarding its record keeping of transactions between the Company and its affiliates. Decision No. 71854 stated, "It is reasonable, and appropriate, and in the public interest to require the Company to prepare an action plan that indicates the specific steps it will take to demonstrate, by means of its day to day record keeping regarding transactions between the Company and all entities with which it conducts business, including, but not limited to, its affiliates and related parties, that its dealings are arm's length, transparent, and well-documented; to require the Company to file the plan within 90 days for Staff's review; and to require Staff to assess the plan and its adequacy, and file a report with Staff's findings and recommendations on the action plan accompanied by a Recommended Order for Commission approval or disapproval of the Company's action plan, within 60 days of receipt of the Company's action plan."<sup>1</sup>

On November 24, 2010, the Company filed an action plan.

The Commission Utilities Division ("Staff") prepared this memorandum and the accompanying recommended order to comply with the Commission's directive in Decision No. 71854 to assess the action plan submitted by Johnson

### II. Company's filed Action Plan

1. Johnson Utilities utilizes the services of an "in-house" C.P.A [Certified Public Accountant] who has provided accounting services for private water and sewer companies in Arizona for 10 years. His job responsibilities include reviewing the Companies [sic] books and ledgers associated with the day to day utility operations and transactions to insure [sic] and verify that they are

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<sup>1</sup> Decision No. 71854 at 69:8-16.

in compliance with NARUC [National Association of Regulatory Utility Commissioners] and Arizona Corporation Commission ("Commission") standards.

2. Johnson Utilities has instituted a company policy requiring a bill of sale along with invoices supporting the cost of the plant that was constructed, pursuant to a line extension agreement with Johnson Utilities, prior to the installation of any water meters. The intent of this policy is to allow the Commission the ability to independently verify the cost of the transactions as well as applicable dates such construction was commenced and completed. Such transparency will allow Staff to easily audit the transactions to ensure that the transactions were entered into at arm's length and in accordance with applicable NARUC and Commission standards.
3. Johnson Utilities will retain competitive bids on construction projects over \$15,000 in accordance with NARUC standards for document retention. These documents will be retained and will be stored in a separate place in the principal place of business. This will allow the Commission to audit these bids to verify the utility plant was constructed in accordance with industry standards as well as assuring that the best value was achieved for Johnson Utilities' customers.
4. If Johnson Utilities determines that it needs to conduct any utility business with an affiliate company, the affiliate company will provide its books and records to the Commission upon request for that transaction, between that Affiliate Company and Johnson Utilities. Currently and on an annual basis, Johnson Utilities already discloses all contracts and agreements to the Commission that it enters into with an Affiliate Company.

### **III. Staff's Assessment of the Company's Filed Action Plan**

The Company is in compliance with Commission directive that required them to file an Action Plan ("Plan"). However, based Staff's review and analysis of the Company's Plan, as filed, the Plan did not provide specific detailed information on how the Company intends to comply with NARUC and Commission record keeping.

First, the Plan assigns responsibility for ensuring compliance with NARUC and Commission standards to a specific individual who has a C.P.A. and ten years of Arizona utility accounting experience and who is currently retained by the Company. This assignment of responsibility to a single individual rather than to a job function is problematic. If this individual's services were to be terminated, it is not clear whether any replacement would be required to have identical qualifications or whether the oversight of compliance would continue at all. Further, the Plan does not describe whether this review is to be performed on an ongoing basis or only upon the filing of a rate case. The Plan should be more generically written to

provide continuous review of recordkeeping by a qualified person and to include a procedure for documenting that the individual responsible did in fact verify the appropriate recording of transactions.

Second, the Plan's provision for a bill of sale and invoices in support of construction costs is not necessarily sufficient to meet regulatory requirements. The supporting records must be organized and provide adequate detail (e.g., description, date, vendor, location, accounts charged by amount, etc.) of the underlying costs with a clear audit trail traceable through the accounting records.

Third, the Plan implies that existence of a bill of sale and supporting documentation ensures that a transaction is at arm's-length. Although those records may be helpful in determining whether a transaction occurred at arm's-length, the mere existence of these records does not demonstrate that a transaction was at arm's-length.

Fourth, the Plan's language regarding competitive bids and record retention is unclear and insufficient. While the plan calls for retaining bids for construction projects over \$15,000, it is unclear that bids will be obtained on all construction projects over \$15,000 so that there will be a complete inventory of bids to retain. Further, the meaning and value of storing bids "in a separate place in the principal place of business" is unclear, but more concerning is the absence of an appropriate off-site backup record retention plan. A backup plan is necessary to avoid loss of records in the event of destruction of the originals.

Fifth, the Plan's language regarding the degree of access the Commission will have to affiliate records for transactions with affiliates is also unclear. A proper review of a transaction may require much more than access to the debits and credits recorded. Further, Commission access to affiliate transactions should not be based on the Company's determination that "it needs to conduct business with an affiliate company." The Commission should have access to affiliate records to evaluate transactions with affiliates absent any unnecessary qualitative restrictions.

Sixth, the Plan does not provide a comprehensive framework for conducting and recording affiliate transactions consistently, equitably and transparently.

#### **IV. Staff's Recommendations Regarding the Company's Filed Action Plan**

In compliance with the directive of Decision No. 71854, Staff recommends that, to address the deficiencies identified in the Company's proposed Action Plan, the Company be required to modify its plan to include the following:

1. That the Company assign the responsibility for maintaining its records in accordance with the NARUC Uniform System of Accounts ("USOA"), Commission Orders, and the Company's other accounting procedures/manuals/guidelines to a job function,

rather than to a specific individual and, further, that the Company provide for a procedure to document the review and verification of transactions for compliance.

2. That the Company adopt and follow the NARUC guidelines for cost allocations and affiliate transactions ("NARUC Guidelines"). See Attachment A.

The NARUC Guidelines provide direction under the following topics:

- A. Definitions
  - B. Cost Allocation Principles
  - C. Cost Allocation Manual
  - D. Affiliate Transactions (Not Tariffed)
  - E. Audit Requirements
  - F. Reporting Requirements
3. That the Company retain information that includes all additions to plant-in-service segregated by plant line item (e.g., Account 304 – Structures and Improvements, etc.) and year. The Company shall retain supporting documentation to substantiate each plant-in-service addition. The Company books of account, and all other books, records, and memoranda which support the entries in such books of account should be kept so as to be able to furnish readily full information as to any item included in any account. Each entry shall be supported by such detailed information as will permit a ready identification, analysis, and verification of all relevant facts.

The books and records mentioned above shall include not only accounting records in a limited technical sense, but all other records, such as minute books, stock books, reports, correspondence, memoranda, etc., which may be useful in developing the history of, or facts regarding, any transaction.

The supporting records should include, but are not limited to actual invoices, main extension agreements, contributions-in-aid-of-construction ("CIAC"), advances-in-aid-of-construction ("AIAC"), and construction contracts. If main extension agreements, CIAC or AIAC are used, they should be supported by underlying invoices.

It should be noted that when plant is constructed by an entity other than the Company, the Company need not take ownership of that plant until it is satisfied that the plant has been built to Company standards and that all required plant accounting documentation has been received by the Company.

4. That for each plant addition occurring after 2008, (the test year end corresponding with the rate case resulting in Decision No. 71854), the Company shall indentify and retain in its records the corresponding amount of investor-provided funds, CIAC, or AIAC associated with each entry to record plant in service.

5. That the Company retain information yearly on all construction work in progress ("CWIP") projects.

The Company should keep its books of account, and all other books, records, and memoranda which support the entries in such books of account so as to be able to furnish readily full information as to any item included in CWIP. Each entry shall be supported by such detailed information as will permit a ready identification, analysis, and verification of all relevant facts.

The books and records mentioned above should include not only accounting records in a limited technical sense, but all other records, such as minute books, stock books, reports, correspondence, memoranda, etc., which may be useful in developing the history of, or facts regarding, any transaction.

The supporting documentation to substantiate CWIP, should include, but is not limited to actual invoices, main extension agreements, CIAC, AIAC and construction contracts. If main extension agreements, CIAC or AIAC are used, they should be supported by underlying invoices.

6. That for each year's CWIP amount occurring after 2008 (the test year end corresponding with the rate case resulting in Decision No. 71854), the Company shall identify and retain in its records the corresponding amount of investor provided funds, CIAC or AIAC associated with each entry to record CWIP.
7. That the records supporting the entries for overhead construction costs be so kept as to show the total amount of each overhead for each year, the nature and amount of each overhead expenditure charged to each construction work order and to each utility plant account, and the basis of distribution of such costs. Each entry should be supported by such detailed information as will permit a ready identification, analysis, and verification of all relevant facts.
8. That the Company retain records for all retirements occurring after 2008 (the test year end corresponding with the rate case resulting in Decision No. 71854), by year, showing the accounts (e.g., specific plant, accumulated depreciation, salvage and cost of removal) and amounts affected along with the supporting documentation for the retirement.
9. That the Company keep its accounts and records so as to be able to furnish accurately and expeditiously statements of all transactions with associated companies and/or affiliates. Those statements must show the general nature of the transactions, the amounts involved and the amounts included in each account prescribed with respect to the transaction.


The Company should not transact business with an affiliate unless the affiliate agrees to provide Commission Staff access to the books and records of the affiliate to the degree required to fully audit, examine or otherwise investigate transactions between the Company and the affiliate. Staff should have access to the books, records, accounts, memoranda and other documents it deems appropriate related to these transactions.

The system of accounts used by the Company will include the necessary accounting records needed to record and compile transactions with each affiliate.

10. That the Company retain supporting documentation for all plant additions and CWIP for years following 2008 (the test year end corresponding with the rate case resulting in Decision No. 71854).
11. That the Company retain general ledgers in excel or compatible format for the years following 2008 (the test year end corresponding with the rate case resulting in Decision No. 71854).
12. That the Company retain a yearly list of all affiliates as defined in A.A.C. R14-2-801 for the years following 2008 (the test year end corresponding with the rate case resulting in Decision No. 71854).
13. That the Company retain general ledgers for its affiliates in excel or compatible format for years following 2008 (the test year end corresponding with the rate case resulting in Decision No. 71854).
14. That the Company obtain competitive bids from non-affiliate entities on construction projects over \$15,000 and retain the bids along with a detailed analysis of its selection evaluation criteria, process and conclusion.

#### IV. Conclusions and Recommendations

Staff recommends that the Company be ordered to modify its proposed action plan to include Staff's recommendations as discussed herein.

*for*   
Steven M. Olea  
Director  
Utilities Division

SMO:JMM:lhmm\RM

ORIGINATOR: Jeffrey M. Michlik

### **Guidelines for Cost Allocations and Affiliate Transactions:**

The following Guidelines for Cost Allocations and Affiliate Transactions (Guidelines) are intended to provide guidance to jurisdictional regulatory authorities and regulated utilities and their affiliates in the development of procedures and recording of transactions for services and products between a regulated entity and affiliates. The prevailing premise of these Guidelines is that allocation methods should not result in subsidization of non-regulated services or products by regulated entities unless authorized by the jurisdictional regulatory authority. These Guidelines are not intended to be rules or regulations prescribing how cost allocations and affiliate transactions are to be handled. They are intended to provide a framework for regulated entities and regulatory authorities in the development of their own policies and procedures for cost allocations and affiliated transactions. Variation in regulatory environment may justify different cost allocation methods than those embodied in the Guidelines.

The Guidelines acknowledge and reference the use of several different practices and methods. It is intended that there be latitude in the application of these guidelines, subject to regulatory oversight. The implementation and compliance with these cost allocations and affiliate transaction guidelines, by regulated utilities under the authority of jurisdictional regulatory commissions, is subject to Federal and state law. Each state or Federal regulatory commission may have unique situations and circumstances that govern affiliate transactions, cost allocations, and/or service or product pricing standards. For example, The Public Utility Holding Company Act of 1935 requires registered holding company systems to price "at cost" the sale of goods and services and the undertaking of construction contracts between affiliate companies.

The Guidelines were developed by the NARUC Staff Subcommittee on Accounts in compliance with the Resolution passed on March 3, 1998 entitled "Resolution Regarding Cost Allocation for the Energy Industry" which directed the Staff Subcommittee on Accounts together with the Staff Subcommittees on Strategic Issues and Gas to prepare for NARUC's consideration, "Guidelines for Energy Cost Allocations." In addition, input was requested from other industry parties. Various levels of input were obtained in the development of the Guidelines from the Edison Electric Institute, American Gas Association, Securities and Exchange Commission, the Federal Energy Regulatory Commission, Rural Utilities Service and the National Rural Electric Cooperatives Association as well as staff of various state public utility commissions.

In some instances, non-structural safeguards as contained in these guidelines may not be sufficient to prevent market power problems in strategic markets such as the generation market. Problems arise when a firm has the ability to raise prices above market for a sustained period and/or impede output of a product or service. Such concerns have led some states to develop codes of conduct to govern relationships between the regulated utility and its non-regulated affiliates. Consideration should be given to any "unique" advantages an incumbent utility would have over competitors in an emerging market such as the retail energy market. A code of conduct should be used in conjunction with guidelines on cost allocations and affiliate transactions.

### **A. DEFINITIONS**

1. **Affiliates** - companies that are related to each other due to common ownership or control.
2. **Attestation Engagement** - one in which a certified public accountant who is in the practice of public accounting is contracted to issue a written communication that expresses a conclusion about the reliability of a written assertion that is the responsibility of another party.

3. Cost Allocation Manual (CAM) - an indexed compilation and documentation of a company's cost allocation policies and related procedures.
4. Cost Allocations - the methods or ratios used to apportion costs. A cost allocator can be based on the origin of costs, as in the case of cost drivers; cost-causative linkage of an indirect nature; or one or more overall factors (also known as general allocators).
5. Common Costs - costs associated with services or products that are of joint benefit between regulated and non-regulated business units.
6. Cost Driver - a measurable event or quantity which influences the level of costs incurred and which can be directly traced to the origin of the costs themselves.
7. Direct Costs - costs which can be specifically identified with a particular service or product.
8. Fully Allocated costs - the sum of the direct costs plus an appropriate share of indirect costs.
9. Incremental pricing - pricing services or products on a basis of only the additional costs added by their operations while one or more pre-existing services or products support the fixed costs.
10. Indirect Costs - costs that cannot be identified with a particular service or product. This includes but not limited to overhead costs, administrative and general, and taxes.
11. Non-regulated - that which is not subject to regulation by regulatory authorities.
12. Prevailing Market Pricing - a generally accepted market value that can be substantiated by clearly comparable transactions, auction or appraisal.
13. Regulated - that which is subject to regulation by regulatory authorities.
14. Subsidization - the recovery of costs from one class of customers or business unit that are attributable to another.

## B. COST ALLOCATION PRINCIPLES

The following allocation principles should be used whenever products or services are provided between a regulated utility and its non-regulated affiliate or division.

1. To the maximum extent practicable, in consideration of administrative costs, costs should be collected and classified on a direct basis for each asset, service or product provided.
2. The general method for charging indirect costs should be on a fully allocated cost basis. Under appropriate circumstances, regulatory authorities may consider incremental cost, prevailing market pricing or other methods for allocating costs and pricing transactions among affiliates.
3. To the extent possible, all direct and allocated costs between regulated and non-regulated services and products should be traceable on the books of the applicable regulated utility to the applicable Uniform System of Accounts. Documentation should be made available to the appropriate regulatory authority upon request regarding transactions between the regulated utility and its affiliates.
4. The allocation methods should apply to the regulated entity's affiliates in order to prevent



subsidization from, and ensure equitable cost sharing among the regulated entity and its affiliates, and vice versa.

5. All costs should be classified to services or products which, by their very nature, are either regulated, non-regulated, or common to both.

6. The primary cost driver of common costs, or a relevant proxy in the absence of a primary cost driver, should be identified and used to allocate the cost between regulated and non-regulated services or products.

7. The indirect costs of each business unit, including the allocated costs of shared services, should be spread to the services or products to which they relate using relevant cost allocators.

#### C. COST ALLOCATION MANUAL (NOT TARIFFED)

Each entity that provides both regulated and non-regulated services or products should maintain a cost allocation manual (CAM) or its equivalent and notify the jurisdictional regulatory authorities of the CAM's existence. The determination of what, if any, information should be held confidential should be based on the statutes and rules of the regulatory agency that requires the information. Any entity required to provide notification of a CAM(s) should make arrangements as necessary and appropriate to ensure competitively sensitive information derived therefrom be kept confidential by the regulator. At a minimum, the CAM should contain the following:

1. An organization chart of the holding company, depicting all affiliates, and regulated entities.
2. A description of all assets, services and products provided to and from the regulated entity and each of its affiliates.
3. A description of all assets, services and products provided by the regulated entity to non-affiliates.
4. A description of the cost allocators and methods used by the regulated entity and the cost allocators and methods used by its affiliates related to the regulated services and products provided to the regulated entity.

#### D. AFFILIATE TRANSACTIONS (NOT TARIFFED)

The affiliate transactions pricing guidelines are based on two assumptions. First, affiliate transactions raise the concern of self-dealing where market forces do not necessarily drive prices. Second, utilities have a natural business incentive to shift costs from non-regulated competitive operations to regulated monopoly operations since recovery is more certain with captive ratepayers. Too much flexibility will lead to subsidization. However, if the affiliate transaction pricing guidelines are too rigid, economic transactions may be discouraged.

The objective of the affiliate transactions' guidelines is to lessen the possibility of subsidization in order to protect monopoly ratepayers and to help establish and preserve competition in the electric generation and the electric and gas supply markets. It provides ample flexibility to accommodate exceptions where the outcome is in the best interest of the utility, its ratepayers and competition. As with any transactions, the burden of proof for any exception from

the general rule rests with the proponent of the exception.

1. Generally, the price for services, products and the use of assets provided by a regulated entity to its non-regulated affiliates should be at the higher of fully allocated costs or prevailing market prices. Under appropriate circumstances, prices could be based on incremental cost, or other pricing mechanisms as determined by the regulator.

2. Generally, the price for services, products and the use of assets provided by a non-regulated affiliate to a regulated affiliate should be at the lower of fully allocated cost or prevailing market prices. Under appropriate circumstances, prices could be based on incremental cost, or other pricing mechanisms as determined by the regulator.

3. Generally, transfer of a capital asset from the utility to its non-regulated affiliate should be at the greater of prevailing market price or net book value, except as otherwise required by law or regulation. Generally, transfer of assets from an affiliate to the utility should be at the lower of prevailing market price or net book value, except as otherwise required by law or regulation. To determine prevailing market value, an appraisal should be required at certain value thresholds as determined by regulators.

4. Entities should maintain all information underlying affiliate transactions with the affiliated utility for a minimum of three years, or as required by law or regulation.

#### E. AUDIT REQUIREMENTS

1. An audit trail should exist with respect to all transactions between the regulated entity and its affiliates that relate to regulated services and products. The regulator should have complete access to all affiliate records necessary to ensure that cost allocations and affiliate transactions are conducted in accordance with the guidelines. Regulators should have complete access to affiliate records, consistent with state statutes, to ensure that the regulator has access to all relevant information necessary to evaluate whether subsidization exists. The auditors, not the audited utilities, should determine what information is relevant for a particular audit objective. Limitations on access would compromise the audit process and impair audit independence.

2. Each regulated entity's cost allocation documentation should be made available to the company's internal auditors for periodic review of the allocation policy and process and to any jurisdictional regulatory authority when appropriate and upon request.

3. Any jurisdictional regulatory authority may request an independent attestation engagement of the CAM. The cost of any independent attestation engagement associated with the CAM, should be shared between regulated and non-regulated operations consistent with the allocation of similar common costs.

4. Any audit of the CAM should not otherwise limit or restrict the authority of state regulatory authorities to have access to the books and records of and audit the operations of jurisdictional utilities.

5. Any entity required to provide access to its books and records should make arrangements as necessary and appropriate to ensure that competitively sensitive information derived therefrom be kept confidential by the regulator.

#### F. REPORTING REQUIREMENTS

1. The regulated entity should report annually the dollar amount of non-tariffed transactions

associated with the provision of each service or product and the use or sale of each asset for the following:

- a. Those provided to each non-regulated affiliate.
- b. Those received from each non-regulated affiliate.
- c. Those provided to non-affiliated entities.

2. Any additional information needed to assure compliance with these Guidelines, such as cost of service data necessary to evaluate subsidization issues, should be provided.

1                                   **BEFORE THE ARIZONA CORPORATION COMMISSION**

2   GARY PIERCE  
      Chairman  
3   BOB STUMP  
      Commissioner  
4   SANDRA D. KENNEDY  
      Commissioner  
5   PAUL NEWMAN  
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6   BRENDA BURNS  
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7  
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DOCKET NO.   WS-02987A-08-0180

DECISION NO. \_\_\_\_\_

ORDER

11  
12  
13   Open Meeting  
   April 27 and 28, 2011  
14   Phoenix, Arizona

15   BY THE COMMISSION:

16                                   FINDINGS OF FACT

17   I.    Introduction and Background

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8 4. The Company's proposed plan is as follows:

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- c. That the Company retain information that includes all additions to plant-in-service segregated by plant line item (e.g., Account 304 – Structures and Improvements, etc.) and year. The Company shall retain supporting documentation to substantiate each plant-in-service addition. The Company books of account, and all other books, records, and memoranda which support the entries in such books of account should be kept so as to be able to furnish readily full information as to any item included in any account. Each entry shall be supported by such detailed information as will permit a ready identification, analysis, and verification of all relevant facts.
- d. The books and records mentioned above shall include not only accounting records in a limited technical sense, but all other records, such as minute books, stock books, reports, correspondence, memoranda, etc., which may be useful in developing the history of, or facts regarding, any transaction.
- e. The supporting records should include, but are not limited to actual invoices, main extension agreements, contributions-in-aid-of-construction (“CIAC”), advances-in-aid-of-construction (“AIAC”), and construction contracts. If main extension agreements, CIAC or AIAC are used they should be supported by underlying invoices.
- f. It should be noted that when plant is constructed by an entity other than the Company, the Company need not take ownership of that plant until it is satisfied that the plant has been built to Company standards and that all required plant accounting documentation has been received by the Company.
- g. That for each plant addition occurring after 2008, (the test year end corresponding with the rate case resulting in Decision No. 71854), the Company shall identify and retain in its records the corresponding amount of investor-provided funds, CIAC, or AIAC associated with each entry to record plant in service.
- h. That the Company retain information yearly on all construction work in progress (“CWIP”) projects.
- i. The Company should keep its books of account, and all other books, records, and memoranda which support the entries in such books of account so as to be able to furnish readily full information as to any item included in CWIP. Each entry shall be supported by such detailed information as will permit a ready identification, analysis, and verification of all relevant facts.
- j. The books and records mentioned above should include not only accounting records in a limited technical sense, but all other records, such as minute books, stock books, reports, correspondence, memoranda, etc., which may be useful in developing the history of, or facts regarding, any transaction.
- k. The supporting documentation to substantiate CWIP, should include, but is not limited to actual invoices, main extension agreements, CIAC, AIAC and



1 construction contracts. If main extension agreements, CIAC or AIAC, are used  
2 they should be supported by underlying invoices.

- 3 l. That for each year's CWIP amount occurring after 2008 (the test year end  
4 corresponding with the rate case resulting in Decision No. 71854), the Company  
5 shall identify and retain in its records the corresponding amount of investor  
6 provided funds, CIAC or AIAC associated with each entry to record CWIP.
- 7 m. That the records supporting the entries for overhead construction costs be so  
8 kept as to show the total amount of each overhead for each year, the nature and  
9 amount of each overhead expenditure charged to each construction work order  
10 and to each utility plant account, and the basis of distribution of such costs.  
11 Each entry should be supported by such detailed information as will permit a  
12 ready identification, analysis, and verification of all relevant facts.
- 13 n. That the Company retain records for all retirements occurring after 2008 (the  
14 test year end corresponding with the rate case resulting in Decision No. 71854),  
15 by year, showing the accounts (e.g., specific plant, accumulated depreciation,  
16 salvage and cost of removal) and amounts affected along with the supporting  
17 documentation for the retirement.
- 18 o. That the Company keep its accounts and records so as to be able to furnish  
19 accurately and expeditiously statements of all transactions with associated  
20 companies and/or affiliates. Those statements must show the general nature of  
21 the transactions, the amounts involved and the amounts included in each  
22 account prescribed with respect to the transaction.
- 23 p. The Company should not transact business with an affiliate unless the affiliate  
24 agrees to provide Commission Staff access to the books and records of the  
25 affiliate to the degree required to fully audit, examine or otherwise investigate  
26 transactions between the Company and the affiliate. Staff should have access to  
27 the books, records, accounts, memoranda and other documents it deems  
28 appropriate related to these transactions.
- q. The system of accounts used by the Company will include the necessary  
accounting records needed to record and compile transactions with each  
affiliate.
- r. That the Company retain supporting documentation for all plant additions and  
CWIP for years following 2008 (the test year end corresponding with the rate  
case resulting in Decision No. 71854).
- s. That the Company retain general ledgers in excel or compatible format for the  
years following 2008 (the test year end corresponding with the rate case  
resulting in Decision No. 71854).

- 1 t. That the Company retain a yearly list of all affiliates for the years following  
2 2008 (the test year end corresponding with the rate case resulting in Decision  
3 No. 71854).
- 4 u. That the Company retain general ledgers for its affiliates in excel or compatible  
5 format for years following 2008 (the test year end corresponding with the rate  
6 case resulting in Decision No. 71854).
- 7 v. That the Company obtain competitive bids from non-affiliate entities on  
8 construction projects over \$15,000 and retain the bids along with a detailed  
9 analysis of its selection evaluation criteria, process and conclusion.

#### 10 CONCLUSIONS OF LAW

11 1. The Company is a public service corporation within the meaning of Article XV of  
12 the Arizona Constitution and A.R.S. §§ 40-250 and 40-252.

13 2. The Commission has jurisdiction over the Company and of the subject matter of the  
14 application.

15 3. Requiring the Company to modify its proposed record keeping plan to include  
16 Staff's recommendations, as discussed herein, is consistent with the Commission's authority under  
17 the Arizona Constitution, Arizona ratemaking statutes, and applicable case law.

18 4. It is in the public interest to require the Company to modify its proposed record  
19 keeping plan to include Staff's recommendations, as discussed herein.

#### 20 ORDER

21 IT IS THEREFORE ORDERED that Staff's recommendations and language related to the  
22 record keeping plan for Johnson Utilities, L.L.C. as discussed in Finding of Fact No. 12 are  
23 reasonable and shall be adopted.

24 IT IS FURTHER ORDERED that Johnson Utilities, L.L.C. immediately implement the  
25 record keeping procedures as discussed by Staff herein.

26 IT IS FURTHER ORDERED that the Company shall file a copy of its plan, incorporating  
27 the modifications as ordered herein, within 30 days of a Decision in this case.

28 ...

...

...

IT IS FURTHER ORDERED that the Company shall file an affidavit within 30 days of a Decision in this case, confirming that the Company is following the record keeping plan and procedures.

IT IS FURTHER ORDERED that this Decision shall become effective immediately.

**BY THE ORDER OF THE ARIZONA CORPORATION COMMISSION**

CHAIRMAN

COMMISSIONER

COMMISSIONER

COMMISSIONER

COMMISSIONER

IN WITNESS WHEREOF, I, ERNEST G. JOHNSON, Executive Director of the Arizona Corporation Commission, have hereunto, set my hand and caused the official seal of this Commission to be affixed at the Capitol, in the City of Phoenix, this \_\_\_\_\_ day of \_\_\_\_\_, 2011.

ERNEST G. JOHNSON  
EXECUTIVE DIRECTOR

DISSENT: \_\_\_\_\_

DISSENT: \_\_\_\_\_

SMO:JMM:lhmm\RM

SERVICE LIST FOR: Johnson Utilities, L.L.C.  
DOCKET NO. WS-02987A-08-0180

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## ATTACHMENT A

**Guidelines for Cost Allocations and Affiliate Transactions:**

The following Guidelines for Cost Allocations and Affiliate Transactions (Guidelines) are intended to provide guidance to jurisdictional regulatory authorities and regulated utilities and their affiliates in the development of procedures and recording of transactions for services and products between a regulated entity and affiliates. The prevailing premise of these Guidelines is that allocation methods should not result in subsidization of non-regulated services or products by regulated entities unless authorized by the jurisdictional regulatory authority. These Guidelines are not intended to be rules or regulations prescribing how cost allocations and affiliate transactions are to be handled. They are intended to provide a framework for regulated entities and regulatory authorities in the development of their own policies and procedures for cost allocations and affiliated transactions. Variation in regulatory environment may justify different cost allocation methods than those embodied in the Guidelines.

The Guidelines acknowledge and reference the use of several different practices and methods. It is intended that there be latitude in the application of these guidelines, subject to regulatory oversight. The implementation and compliance with these cost allocations and affiliate transaction guidelines, by regulated utilities under the authority of jurisdictional regulatory commissions, is subject to Federal and state law. Each state or Federal regulatory commission may have unique situations and circumstances that govern affiliate transactions, cost allocations, and/or service or product pricing standards. For example, The Public Utility Holding Company Act of 1935 requires registered holding company systems to price "at cost" the sale of goods and services and the undertaking of construction contracts between affiliate companies.

The Guidelines were developed by the NARUC Staff Subcommittee on Accounts in compliance with the Resolution passed on March 3, 1998 entitled "Resolution Regarding Cost Allocation for the Energy Industry" which directed the Staff Subcommittee on Accounts together with the Staff Subcommittees on Strategic Issues and Gas to prepare for NARUC's consideration, "Guidelines for Energy Cost Allocations." In addition, input was requested from other industry parties. Various levels of input were obtained in the development of the Guidelines from the Edison Electric Institute, American Gas Association, Securities and Exchange Commission, the Federal Energy Regulatory Commission, Rural Utilities Service and the National Rural Electric Cooperatives Association as well as staff of various state public utility commissions.

In some instances, non-structural safeguards as contained in these guidelines may not be sufficient to prevent market power problems in strategic markets such as the generation market. Problems arise when a firm has the ability to raise prices above market for a sustained period and/or impede output of a product or service. Such concerns have led some states to develop codes of conduct to govern relationships between the regulated utility and its non-regulated affiliates. Consideration should be given to any "unique" advantages an incumbent utility would have over competitors in an emerging market such as the retail energy market. A code of conduct should be used in conjunction with guidelines on cost allocations and affiliate transactions.

**A. DEFINITIONS**

1. Affiliates - companies that are related to each other due to common ownership or control.
2. Attestation Engagement - one in which a certified public accountant who is in the practice of public accounting is contracted to issue a written communication that expresses a conclusion about the reliability of a written assertion that is the responsibility of another party.

3. Cost Allocation Manual (CAM) - an indexed compilation and documentation of a company's cost allocation policies and related procedures.
4. Cost Allocations - the methods or ratios used to apportion costs. A cost allocator can be based on the origin of costs, as in the case of cost drivers; cost-causative linkage of an indirect nature; or one or more overall factors (also known as general allocators).
5. Common Costs - costs associated with services or products that are of joint benefit between regulated and non-regulated business units.
6. Cost Driver - a measurable event or quantity which influences the level of costs incurred and which can be directly traced to the origin of the costs themselves.
7. Direct Costs - costs which can be specifically identified with a particular service or product.
8. Fully Allocated costs - the sum of the direct costs plus an appropriate share of indirect costs.
9. Incremental pricing - pricing services or products on a basis of only the additional costs added by their operations while one or more pre-existing services or products support the fixed costs.
10. Indirect Costs - costs that cannot be identified with a particular service or product. This includes but not limited to overhead costs, administrative and general, and taxes.
11. Non-regulated - that which is not subject to regulation by regulatory authorities.
12. Prevailing Market Pricing - a generally accepted market value that can be substantiated by clearly comparable transactions, auction or appraisal.
13. Regulated - that which is subject to regulation by regulatory authorities.
14. Subsidization - the recovery of costs from one class of customers or business unit that are attributable to another.

## B. COST ALLOCATION PRINCIPLES

The following allocation principles should be used whenever products or services are provided between a regulated utility and its non-regulated affiliate or division.

1. To the maximum extent practicable, in consideration of administrative costs, costs should be collected and classified on a direct basis for each asset, service or product provided.
2. The general method for charging indirect costs should be on a fully allocated cost basis. Under appropriate circumstances, regulatory authorities may consider incremental cost, prevailing market pricing or other methods for allocating costs and pricing transactions among affiliates.
3. To the extent possible, all direct and allocated costs between regulated and non-regulated services and products should be traceable on the books of the applicable regulated utility to the applicable Uniform System of Accounts. Documentation should be made available to the appropriate regulatory authority upon request regarding transactions between the regulated utility and its affiliates.
4. The allocation methods should apply to the regulated entity's affiliates in order to prevent

subsidization from, and ensure equitable cost sharing among the regulated entity and its affiliates, and vice versa.

5. All costs should be classified to services or products which, by their very nature, are either regulated, non-regulated, or common to both.

6. The primary cost driver of common costs, or a relevant proxy in the absence of a primary cost driver, should be identified and used to allocate the cost between regulated and non-regulated services or products.

7. The indirect costs of each business unit, including the allocated costs of shared services, should be spread to the services or products to which they relate using relevant cost allocators.

#### C. COST ALLOCATION MANUAL (NOT TARIFFED)

Each entity that provides both regulated and non-regulated services or products should maintain a cost allocation manual (CAM) or its equivalent and notify the jurisdictional regulatory authorities of the CAM's existence. The determination of what, if any, information should be held confidential should be based on the statutes and rules of the regulatory agency that requires the information. Any entity required to provide notification of a CAM(s) should make arrangements as necessary and appropriate to ensure competitively sensitive information derived therefrom be kept confidential by the regulator. At a minimum, the CAM should contain the following:

1. An organization chart of the holding company, depicting all affiliates, and regulated entities.
2. A description of all assets, services and products provided to and from the regulated entity and each of its affiliates.
3. A description of all assets, services and products provided by the regulated entity to non-affiliates.
4. A description of the cost allocators and methods used by the regulated entity and the cost allocators and methods used by its affiliates related to the regulated services and products provided to the regulated entity.

#### D. AFFILIATE TRANSACTIONS (NOT TARIFFED)

The affiliate transactions pricing guidelines are based on two assumptions. First, affiliate transactions raise the concern of self-dealing where market forces do not necessarily drive prices. Second, utilities have a natural business incentive to shift costs from non-regulated competitive operations to regulated monopoly operations since recovery is more certain with captive ratepayers. Too much flexibility will lead to subsidization. However, if the affiliate transaction pricing guidelines are too rigid, economic transactions may be discouraged.

The objective of the affiliate transactions' guidelines is to lessen the possibility of subsidization in order to protect monopoly ratepayers and to help establish and preserve competition in the electric generation and the electric and gas supply markets. It provides ample flexibility to accommodate exceptions where the outcome is in the best interest of the utility, its ratepayers and competition. As with any transactions, the burden of proof for any exception from



the general rule rests with the proponent of the exception.

1. Generally, the price for services, products and the use of assets provided by a regulated entity to its non-regulated affiliates should be at the higher of fully allocated costs or prevailing market prices. Under appropriate circumstances, prices could be based on incremental cost, or other pricing mechanisms as determined by the regulator.
2. Generally, the price for services, products and the use of assets provided by a non-regulated affiliate to a regulated affiliate should be at the lower of fully allocated cost or prevailing market prices. Under appropriate circumstances, prices could be based on incremental cost, or other pricing mechanisms as determined by the regulator.
3. Generally, transfer of a capital asset from the utility to its non-regulated affiliate should be at the greater of prevailing market price or net book value, except as otherwise required by law or regulation. Generally, transfer of assets from an affiliate to the utility should be at the lower of prevailing market price or net book value, except as otherwise required by law or regulation. To determine prevailing market value, an appraisal should be required at certain value thresholds as determined by regulators.
4. Entities should maintain all information underlying affiliate transactions with the affiliated utility for a minimum of three years, or as required by law or regulation.

#### E. AUDIT REQUIREMENTS

1. An audit trail should exist with respect to all transactions between the regulated entity and its affiliates that relate to regulated services and products. The regulator should have complete access to all affiliate records necessary to ensure that cost allocations and affiliate transactions are conducted in accordance with the guidelines. Regulators should have complete access to affiliate records, consistent with state statutes, to ensure that the regulator has access to all relevant information necessary to evaluate whether subsidization exists. The auditors, not the audited utilities, should determine what information is relevant for a particular audit objective. Limitations on access would compromise the audit process and impair audit independence.
2. Each regulated entity's cost allocation documentation should be made available to the company's internal auditors for periodic review of the allocation policy and process and to any jurisdictional regulatory authority when appropriate and upon request.
3. Any jurisdictional regulatory authority may request an independent attestation engagement of the CAM. The cost of any independent attestation engagement associated with the CAM, should be shared between regulated and non-regulated operations consistent with the allocation of similar common costs.
4. Any audit of the CAM should not otherwise limit or restrict the authority of state regulatory authorities to have access to the books and records of and audit the operations of jurisdictional utilities.
5. Any entity required to provide access to its books and records should make arrangements as necessary and appropriate to ensure that competitively sensitive information derived therefrom be kept confidential by the regulator.

#### F. REPORTING REQUIREMENTS

1. The regulated entity should report annually the dollar amount of non-tariffed transactions

associated with the provision of each service or product and the use or sale of each asset for the following:

- a. Those provided to each non-regulated affiliate.
  - b. Those received from each non-regulated affiliate.
  - c. Those provided to non-affiliated entities.
2. Any additional information needed to assure compliance with these Guidelines, such as cost of service data necessary to evaluate subsidization issues, should be provided.